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No. 26

In the Supreme Court of the United States

OCTOBER TERM, 1939

F. H. E. OIL COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 26–32) is unreported. The opinion of the Circuit Court of Appeals (R. 45–49) is reported in 102 F. (2d) 596.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 21, 1939. (R. 49–50.) The petition for a writ of certiorari was filed April 4, 1939, and was granted May 1, 1939. (R. 51.) The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Section 114 (b) (3) of the Revenue Act of 1932 allows an arbitrary deduction for depletion of oil and gas property in the amount of 27½% of the gross income from the property during the year, but provides that the "allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property".

In computing its taxable net income, the taxpayer deducted development expenditures. May it refuse to take these same deductions in computing net income for the purpose of applying the 50 per cent limitation on the depletion allowance?

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * *
>
> (1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *
>
> * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 221. *Depletion of mines, oil and gas wells, other natural deposits, and timbers; depreciation of improvements.*—

* * * * *

(h) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3), and (4) and articles 221 to 248, inclusive, means the "gross income from the property" as defined in paragraph (g) less the allowable deductions attributable to the mineral property upon which the depletion

is claimed and the allowable deductions attributable to the processes listed in paragraph (g) insofar as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. * * *

* * * * *

ART. 236. *Charges to capital and to expense in the case of oil and gas wells.*—(a) Items chargeable to capital or to expense at taxpayer's option.

(1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, roadmaking, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical struc-

tures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. * * *

* * * * *

STATEMENT

This case involves the same issue [1] as is presented in *Helvering* v. *Wilshire Oil Co.*, No. 1, present Term, except that the taxable period here is the fiscal year ending January 31, 1932, and is consequently governed by the Revenue Act of 1932.[2]

The taxpayer is a Texas corporation engaged in the business of producing oil and gas from various properties located in what is known as the West Texas field. Throughout its entire history, it fol-

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[1] There were four separate issues before the Board of Tax Appeals, but of those only one, issue No. 4 (R. 31–32), is present here.

[2] Section 1 of the 1932 Act provides that "The provisions of this title shall apply only to the taxable year 1932 and succeeding taxable years." And Section 48 (a) provides that "The first taxable year, to be called the taxable year 1932, shall be the calendar year 1932 or any fiscal year ending during the calendar year 1932."

However, pursuant to Sections 14 and 105, where a taxable period embraces years with different laws, there are provisions for computations under both laws and apportioning the tax to the periods within both years. At most, these provisions merely mean that rates, etc., prevailing under the Revenue Act of 1928 would be applied with respect to that portion of the fiscal year represented by the period prior to 1932. But the 1932 Act is nevertheless the operative statute which imposes the entire tax, and moreover governs even as to rates, etc., with respect to that portion of the fiscal year represented by the period following December 31, 1931.

lowed the practice of charging to expense and deducting from taxable income all intangible drilling expenses. (R. 39.) During the fiscal year ended January 31, 1932, it thus charged to expense and deducted in its income tax return development expenses in the amount of $34,030.70. (R. 18A.) The Board of Tax Appeals held, however, that such expenses need not be deducted in applying the 50 per cent limitation in the depletion allowance. (R. 31–32.) The Circuit Court of Appeals reversed, holding that such expenses, if deducted currently in computing taxable net income, should likewise be deducted in computing the net income from the property upon which the depletion allowance is based. (R. 45–49.)

ARGUMENT

The issue here presented is fully explored in our brief in *Helvering* v. *Wilshire Oil Co.*, No. 1, which is to be argued immediately preceding the instant case.

The only difference between the cases is that the *Wilshire* case arises under Section 114 (b) (3) of the 1928 Act, whereas the present case arises under the like numbered provisions of the 1932 Act. If anything, this difference operates in the Government's favor. For, the applicable regulations promulgated under the 1932 Act are similar to those issued under the preceding statute, and the reenactment of the pertinent provisions in the 1932

Act can be treated as Congressional approval of these regulations. However, we think that nothing should turn on this difference, and that the regulations issued under the 1928 Act are as valid as those involved herein.

The decision below is correct and should be affirmed.

Respectfully submitted.

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SEPTEMBER, 1939.

U. S. GOVERNMENT PRINTING OFFICE: 1939

SUPREME COURT OF THE UNITED STATES.

No. 26.—October Term, 1939.

F. H. E. Oil Company, Petitioner, vs. Guy T. Helvering, Commissioner of Internal Revenue. } On Writ of Certiorari to United States Circuit Court of Appeals, Fifth Circuit.

[November 6, 1939.]

Mr. Justice Douglas delivered the opinion of the Court.

This case presents the same issue as is involved in No. 1, *Helvering* v. *Wilshire Oil Co., Inc.*, ante p. , except that it arises under the Revenue Act of 1932 (47 Stat. 169). In computing its taxable net income under that Act, petitioner deducted certain development expenditures as it had done since its organization in 1925. But it refused to take these same deductions in computing net income for the purpose of applying the 50 per cent limitation on the depletion allowance, as provided in § 114 (b) (3) of the 1932 Act.[1] That section, so far as material here, was the same as § 114 (b) (3) of the 1928 Act (45 Stat. 791). And Treasury Regulations 77, Art. 221 (h) promulgated under the 1932 Act[2] defined "net income . . . from the property" as used in § 114 (b) (3) so as to require "development costs" of the kind here involved to be deducted from "gross

[1] That section provided:

"In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

[2] Section 23(l) of the Revenue Act of 1932 provided:

"In computing net income there shall be allowed as deductions:

"(1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. . . ."

income from the property".[3] The Board of Tax Appeals held that petitioner need not deduct these development expenditures in applying the 50 per cent limitation on depletion allowance (36 B. T. A. 1327) and the Circuit Court of Appeals reversed (102 F. (2d) 596). Since we have this day decided in *Helvering* v. *Wilshire Oil Co., Inc., supra*, that comparable regulations under the 1928 Act were lawful, *a fortiori* those here involved are valid and binding on petitioner. The judgment of the court below was therefore right and is

Affirmed.

Mr. Justice BUTLER and Mr. Justice REED took no part in the consideration or disposition of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.

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[3] Treasury Regulations 77, Art. 221(h) provided:

"'Net income of the taxpayer (computed without allowance for depletion) from the property,' as used in section 114(b)(2), (3), and (4) and articles 221 to 248, inclusive, means the 'gross income from the property' as defined in paragraph (g) less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (g) insofar as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. . . ."